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German Tax and Legal News

BFH delivers long-awaited decision on taxation of carried interest from business-type fund structures

Court confirms treatment is based on a look-through approach; preferential tax regime may apply based on underlying income

In a long-awaited decision dated 11 December 2018 (and published on 29 May 2019), Germany's federal tax court (BFH) ruled on the taxation of carried interest from business-type fund structures. The BFH clarified that the tax treatment of carried interest from business-type fund structures depends on the type of the underlying income of the fund that results in the carried interest income. Therefore, where the underlying income is dividends or capital gains, the carried interest income may benefit from a tax exemption (or a partial tax exemption) for dividends or capital gains.

In general terms, "carried interest" is a share of a fund's income derived by a fund manager that holds a participation in the fund, in exchange for managing the fund. Under the German income tax code (ITC), the treatment of carried interest depends on whether the fund has a "business-type fund structure," i.e. it generates business income based on its activities or it is deemed to generate business income based on its legal structure. Carried interest derived by an individual from a mere asset managing, non-business type fund structure is treated as income from self-employment. However, rather than being fully taxable (as generally is the case for income from self-employment), the ITC provides for a preferential tax regime for such income, i.e. 40% is exempt from tax. For carried interest derived from business-type fund structures, the tax authorities took different views in the past that, in most cases, led to less advantageous tax treatment compared to the treatment of carried interest from asset managing, non-business type fund structures.

The BFH determined in the case that carried interest from business-type fund structures cannot be classified as self-employment income because, based on the clear wording of the ITC, this classification applies only for mere asset managing, non-business type fund structures. The court classified the carried interest as ordinary income from the individual's participation in the fund structure and applied a "look-through" approach, under which the carried interest income is taxed based on the classification of the underlying income at the level of the fund. In the case of dividends or capital gains from the sale of shares, this generally would allow the fund manager to apply preferential tax treatment (a 40% tax exemption for qualifying individuals).

The decision also clarifies that this treatment applies not only to fund structures that generate business income based on their activities, but also to fund structures that generate business income based on the legal features of the relevant structure.

The BFH's decision is a welcome clarification for taxpayers and provides valuable guidance for venture capital and private equity investors. The decision could facilitate the establishment of such fund structures from a German tax perspective and clarifies the applicable tax treatment. However, it is unclear how the tax authorities will respond to the decision, and whether they will apply it only under the specific circumstances that were present in the case, or on a broader basis.

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